Global Investment Strategy – 3rd Quarter 2011

In every stage of the business cycle, investors are confronted with a mixed array of data that point to different trajectories. The same is true of the current stage of the cycle. As markets climb higher, the smaller levels of upside "reward" left makes it harder to remain overweight in risk assets as the data becomes more mixed.

While there were data points that pointed to improved confidence and production, there was also evidence that indicated persistent weakness in certain segments. At UOB Asset Management, we do not like to advocate "sitting on the fence", as we believe that there are always investment opportunities around. Accordingly, we raised our calls on equities from neutral to overweight early in 2009, and continued to advocate an overweight position in equities and commodities all the way through the second quarter of 2011.

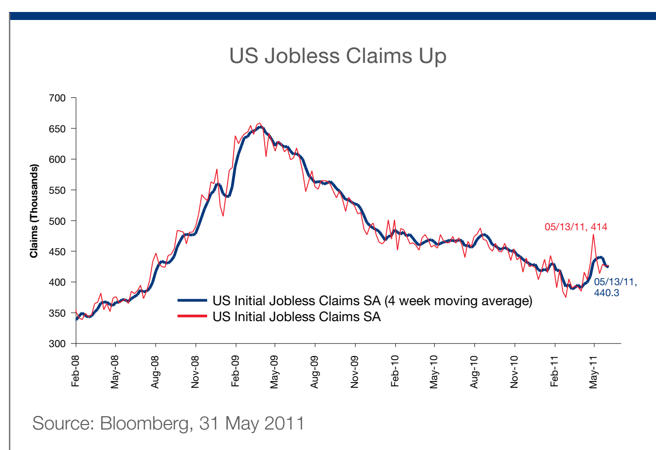
However, there are occasions when a cautious stance is merited. This is especially so when the global economy is caught in a fine balance between positive growth drivers and persistently weak data and serious risk factors. And we believe that now is the time to adopt that stance.

The bear case

The recent economic data seem to indicate a slower pace of economic growth in the US. Readings from both manufacturing and services signalled a pull-back in economic activity, while the labour market conditions have weakened lately. To top it all, US gross domestic product disappointed with growth of 1.8% – below the consensus estimate of 2.2%[1].

More troubling was the level of hiring activity. Since last month, weekly jobless claims have been north of 400,000 for more than three weeks now, with the latest figure coming in at 414,000[2]. Claims of 400,000 and above indicates that the level of job creation is insufficient in absorbing the surplus labour in the US market.

US Jobless Claims Up



Source: Bloomberg, 31 May 2011

[1] Source: Bloomberg, 11 June 2011
[2] Source: Bloomberg, 31 May 2011

Non-farm payrolls rose by 54,000 in May as the private sector posted the smallest job gain in nearly a year. Meanwhile, unemployment rate unexpectedly rose to 9.1% in May[3]. Indeed, overall job growth continues to be restrained by the fundamentals that include a lack of expected sales by many private firms as well as uncertainty about future healthcare costs and tax burdens.

What makes the present slowdown more worrying is that not only is it similar to the summer slowdown last year, but that it has coincided with the end of the Fed's large scale asset purchase program. The US's second round of quantitative easing (QE2) seems to have helped turn the tide on deflation expectations, drive equity markets higher, turn around the collapsing economic data while also suppressing yields in the middle segment of the curve. The risk this time is that without deflationary fears, the likelihood of further policy support (ie QE3), seems much lower even if the economic data is weakening.

Across the Atlantic, troubles in the Old World continue to make the headlines. Top of the list is Greece, which potentially faces delays in aid disbursement. Also, the Hellenistic state saw its sovereign ratings downgraded again. Unfortunately for Greece, its troubles are unlikely to dissuade the European Central Bank (ECB) from tightening policy later this year. Therefore, the Greek economy appears headed for further challenges as fiscal austerity combined with rising interest rates make recovering more difficult.

Another issue is the fragility of the global financial system. Any major event, such as a potential Greek exit from the euro area, could trigger a relapse in the worldwide market turmoil and send the global economy into a tailspin.

The bull case

Indeed, a few bright spots of data do shine through, leading us to consider the possibility that the current rollover in data numbers could be short term, and that there could be underlying factors supporting a sustained appetite for risk assets over the medium term.

The first factor underpinning the bullish view is the string of strong corporate profits reported over the most recent earnings season. Corporate profits in the US have been rising strongly toward US$1.5 trillion since early 2009 and have just recently surpassed their pre-crisis levels[4].

This pattern in earnings is a hint that the US is entering its second phase of recovery from the 2008 downturn. The first phase of economic recovery typically occurs due to accommodative monetary policy and government spending. This is then followed by expansion in the private sector as corporations grow and business confidence increases.

Secondly, while unemployment numbers have ticked up, it is fair to say that jobs gains, while not rising fast enough, are not slowing down significantly. Given how deep the most recent downturn was, it could be argued that the US labour markets might just need more time to recover.

Thirdly, the Fed-induced rates suppression has widened the gap between equity yields and bond yields. Typically, this indicates that stocks are cheaper than bonds based on historical patterns, and therefore, there could be some value in picking up good equity names.

[3] *Source: Bloomberg, 8 June 2011*
[4] *Source: Bloomberg, 8 June 2011*

Reading the signs

Acknowledging a fork in the road is often thought to be a lot less actionable than committing to an expected market direction. However, there are still times when it is wise to exercise caution and wait till the dust has settled. In short, it is important to identify the "road signs" that are most meaningful in helping us to make a decision when we should.

The first "road sign" to watch out for is the global Purchasing Managers Index (PMI) data, US jobs data, and US consumption trends. Basically, jobs play an important role in keeping the recovery cycle turning and continuous weakness in jobs data could adversely reduce the probability and strength of a period of economic recovery and growth.

The second indicator that we would be monitoring would be volatility in the markets. As mentioned earlier, market fear is still hovering at benign levels, and this could mean that investors are either confident, complacent, or maybe even both. As such, any sharp rises in volatility could be a leading indicator that risk appetite might be starting to falter.

And, lastly, the third major "road sign" that we will be watching out for is Treasury yield movement. In the last month or so, yields for US 10-year Treasuries have slid to 3.1% from 3.6%[5]. In a sense, the rates market has already priced in a slower pace of growth. However, if growth decelerates sharply, while cost of borrowing fails to decline further, then this could be near-term negative for the economy. QE 2 program was initiated partly to lower yields with the aim of stimulating business spending. Therefore, if the situation significantly worsens from here, while 10-year yields stays sticky at current levels, QE3 cannot be ruled out. But as we said earlier, this is not our base case at the moment.

3rd Quarter 2011 Asset Allocation

	Comments	Q3 2011	Q2 2011	Change
Equities *Downgrade to neutral*	Roll-over of key leading indicators is key factor in adopting a cautious stance. Any significant slowdown in the US means that China and others may follow suit. Additionally, the spectre of Greek debt woes weighing down on sentiments means that equities may not have significant upside from current levels.	55%	60%	-5%
Bonds *Remaining underweight*	The end of QE2 and high inflation are reasons to be slightly bearish on the asset class. However, we are still more positive on corporate credits than sovereign issues, and prefer Emerging Markets (EM) to developed economies. In terms of sector, we like the commodities space, and especially the exploration and production segment.	35%	27%	8%
Commodities *Maintaining overweight*	We are overweight in commodities primarily because of our bullish views on gold. The positive call on yellow metal is due to our cautious view that the US economy is poised for a slowdown and therefore, a safe haven asset like gold will benefit from a risk off mode.	6%	10%	-4%
Cash instruments *Overweight*	-	4%	3%	1%

[5] *Source: Bloomberg, 23 May 2011*

Neutral position in Equities

The tussle between positive macro backdrop and a longer list of tail risks means that caution is needed when investing in stocks in the third quarter of 2011. The latest patch of soft data has coincided with the persistent troubles in Europe, concerns over the US debt ceiling and the end of stimulus measures in June 2011.

In particular, it is not clear if equity markets can continue to push higher in a post QE2 world, where additional liquidity is no longer available. This comes as the earlier rallies in equity markets could be partially attributed to the advent of extraordinary stimulus policies, while yields trended lower on fresh capital injection.

Although US equities have held up pretty well thus far, the gains were partly a result of positive earnings surprises, and the roll-over in economic leading indicators has led investors to question if the upside surprises are sustainable.

The **US** economy is clearly slowing, with most leading indicators pointing to slower mode of expansion in the coming quarters. From Institute for Supply Management (ISM) manufacturing, new orders to jobless claims, the readings have mostly rolled over, and it is not clear if the soft patch represented a minor blip or represents a much more chronic slowdown. The silver lining is that confidence level is now higher, with little talk of “double dip”. Overall, we are still slightly overweight in US stocks.

In **Europe**, the peripheral countries continue to struggle under the weight of debt troubles, and it may take a while longer for the continent to rid itself of those woes. Delays in aid disbursement and the like have surfaced, and will likely be an overhang on equity markets there. For this reason, we are underweight in Europe.

For **Japan**, the recent earthquake has meant higher public debt and production disruption. Near time, the poor sentiments will be a drag, while the valuations are not compelling. Therefore, we remain underweight in Japan.

We have reverted to our overweight stance in **Asia ex Japan**. The risk-return profile for the region is far more attractive than stocks in the developed world, and we still think that Asian equities are still attractively priced with healthy growth prospects.

We continue to like **Latin America** for its strong domestic growth. While there are some near-term risks due to higher inflation, the central banks are generally ahead of the curve in fighting inflation. The region continues to offer strong long-term investment opportunities for equity investors. We remain overweight in Latin America.

Retain underweight position in Bonds

Governments Bonds may face further policy headwinds, as central banks tighten monetary policies to rein in price pressures. The end of monetary stimulus measures means that there is downside risk in safe haven sovereigns. In US, although we do not expect Fed to tighten rates, neither do we expect Ben Bernanke to announce another QE. In this environment, downside risk is heightened, and therefore, we remain cautious on developed market sovereigns.

Additionally, the troubles in four members of the Euro zone (Portugal, Ireland, Greece and Spain) will probably deter the ECB from hiking policy rate by 50 basis points later this year. Also, markets may price in higher risk premiums on further bad news from Europe. Ultimately, the EU and IMF are expected to expand the bailout funds to keep Greece afloat. This will further the case of kicking the can down the road as Greece will require some forms of debt restructuring before 2013.Within the European sovereign segment, we favour a tactical buy on Spain sovereigns for spreads tightening against core yields.

In EM, we see the central banks continue to implement more aggressive tightening of monetary policies. Therefore, the higher carry on the local currencies debts is likely to attract more foreign inflows. Looking ahead, better credit fundamentals across all global EM debt will underpin the positive performance.

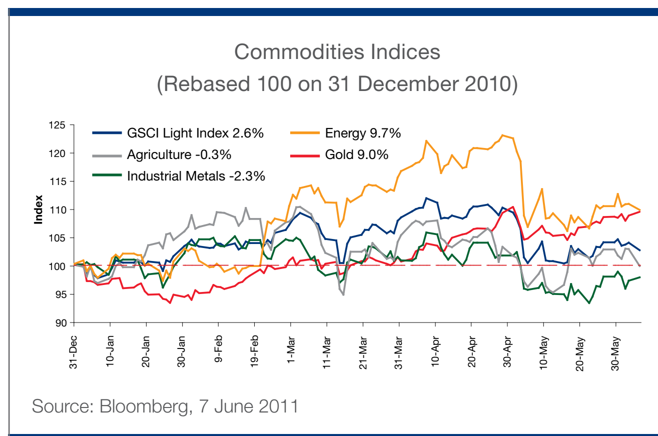
Corporate Bonds is still our preferred segment, thanks to the better risk-return profiles relative to sovereigns. In terms of country and sector recommendations, we see attractive valuations and improving fundamentals among the US banks and commodities segment. Capital levels at US banks continue to improve, while yields trade wide of investment grade levels. In energy, market fundamentals remain constructive. A combination of steady US growth, a weak US dollar, low global interest rates, and robust growth in emerging economies is expected to benefit this sector. We prefer segments with upstream exposure, and continue to overweight the Exploration and Production (E&P) segment.

In Asian fixed income, we prefer non-investment grade credits as high yield credits are generally less sensitive to higher interest rates due to their larger spreads over US Treasuries.

Maintain overweight position in Commodities

We retain our positive view on commodities, albeit with a slightly more defensive positioning between the main commodity sub-sectors. We continue to believe that the overall policy in the US and other leading economies is to support growth while domestic demand recovers. As previously noted, this process may be accompanied by near-term volatility given the end of the US Fed's stimulus program, ongoing problems with the peripheral Euro zone economies and cooling measures by some EM governments. However, there are also encouraging signs such as near-record steel production in China and downward inventory trends in certain industrial metals.

Our key overweight position remains in **Gold & Precious Metals** given the unknown consequences of prolonged monetary stimulus on future inflation and currency stability. The recent quarterly update by the World Gold Council notes gold is benefitting from negative real interest rates in many leading economies. Negative real rates are likely to continue into second half of 2011. Central banks remain aggregate net buyers of gold, with the strongest buying coming from developing economies. Retail investment demand from India and China has seen three consecutive quarters of strong double-digit growth, and is now at record levels in value terms.



Commodities Indices
(Rebased 100 on 31 December 2010)

Source: Bloomberg, 7 June 2011

We have an overweight position in **Bulk Commodities** and a neutral position in **Base Metals**. While some economists are concerned by weakness in some of China's leading economic indicators, this should be viewed as a sign that significant further tightening of policy is not needed. Moreover, key commodity end use indicators (such as floor space under construction) are showing solid growth. Chinese steel production is running in excess of 700 million tonnes per annum and is supportive of iron ore and coking coal prices[6]. The outlook for thermal coal prices is also positive given poor Chinese hydropower output and a weaker outlook for nuclear power following the Fukushima incident.

We have moved to a neutral position in **Agriculture**. With the exception of corn, prices for key commodities have generally corrected in the absence of any weather-related supply shocks. However, we are now moving into the key summer months for Northern hemisphere harvests, and investors will be sensitive to any shortfalls in current high projections for grain harvests. Agricultural futures continue to forecast a downturn in prices towards the end of calendar 2011.

Within the **Energy space**, we have moved to a neutral position in Crude Oil and underweight position in Natural Gas. Fears of disruption to Middle East supplies have caused a spike in near-term spot prices and lead to higher prices for international crudes such as Brent relative to US benchmarks such as West Texas Intermediate. We are reducing our weights in lieu of easing unrests in the region with notably Libya approaching resolution soon in our view. Underlying demand remains strong despite recent downward adjustments by agencies such as the International Energy Agency (IEA) forecasting that 2011 will be a record year for demand. Crude oil inventories have now moved to normalised levels with diesel demand picking up in recent months in line with global economic recovery. Non-OECD demand continues to be strong amidst higher oil prices. Meanwhile US natural gas prices remain depressed due to strong growth in shale gas production while LNG prices remain robust.

[6] *Source: UBS, Global Steel Market Update, 21 June 2011*